State of Washington
DEPARTMENT OF FINANCIAL INSTITUTIONS
Division of Consumer Services
Memo From The Investigation/Enforcement Section

Date:	April 27, 2000
To:	Director John Bley, Assistant Director Mark Thomson, Special Policy and Enforcement Administrator Scott Jarvis
From:	Chuck Cross, Supervisor Investigation/Enforcement
Subject:	Predatory Lending Practices

This memo is an overview of various types of predatory lending practices that have been identified by the Department of Financial Institutions (DFI). These practices may be conducted by mortgage brokers, mortgage lenders, banks, or others with access to financing arrangements. In this memo these groups are combined into a single term, "mortgage company."

DFI has found that the majority of deceptive practices take place in refinance transactions for "subprime" or "hard money" loans. The apparent reason for this is that a refinance transaction involves fewer parties than a purchase transaction. The more parties involved, the more difficult the artifice is to sell or cover up.

Some mortgage companies have become very proficient with deceptive sales pitches in recent years. The perpetrators of this type of consumer fraud have designed sales scripts for their loan officers that overtly quote the regulations and requirements while subverting the meaning of those regulations and requirements. When removed from the context of the sales meeting the scripts can appear to be innocuous forms of solicitation.

Regulatory efforts to uncover these practices have been confounded by "clean files" in which the mortgage company has taken great care to dot all "i's" and cross all "t's" for appearance sake. For example: full disclosures that were never delivered to the borrower are available in the loan files for examiner review. It is not until the regulatory investigator has cause to interview individual borrowers that the failure to disclose is discovered. Additionally, borrowers are sometimes required to sign documents stating that they have been fully apprised of all elements of their loans including federally required disclosures, whether full disclosure has occurred or not.

Following is a list and discussion of the primary types of deception, fraud and predatory practices identified by DFI in the last couple of years. This list is not all-inclusive, but rather addresses the chief problems we have noted in parts of the industry. If requested I would be happy to provide a follow-up list of recommendations to address and help correct each of these types of deception.

<u>Loan Type</u>

DFI has identified large numbers of borrowers who have apparently been deceived about the type of loan they have transacted for. Loan type deception is generally related to the sale or delivery of an adjustable rate mortgage (ARM) in place of a desired fixed rate mortgage. The borrower is not alerted to the ARM by the rate associated with the ARM, because it will often be at a start rate approximating that which is currently being offered on fixed rate mortgages.

This deception is all the more egregious because the conventional ARM will generally carry a rate starting much lower than the fixed rate. The result is that not only is the borrower deceived into the ARM, but a high rate ARM as well. These loans may be tied to volatile indices, have short adjustment periods, and high annual and lifetime caps. To further compound the injury to the borrower, these high rate ARMs usually carry a large prepayment penalty (discussed later), making it cost prohibitive for the borrower to refinance the loan once they identify the deception.

The following methods of deception have been identified:

1. The borrower is solicited for a fixed rate mortgage with the promise or understanding of a conventional market rate. The borrower unknowingly signs for an ARM. The borrower becomes aware of the ARM at the first payment adjustment date (6 months or 1 year). There are a variety of ways in which the "signer" is able to obtain closing signatures from the borrower. Some or all of the following may be employed:
   a. The mortgage company's own staff or affiliated escrow company handle the signing of closing papers. It is impractical for this degree of deception to take place when the signing is conducted by an independent third party closer. However, DFI has seen situations in which non-affiliated closing companies do assist the mortgage company in the fraud.
   b. The signer employs techniques to hide the pertinent information that would alert the borrower to the ARM loan such as, placing Post-It Notes over information, holding a hand over parts of disclosures while pointing towards other parts of the disclosures, and changing the order of multiple page documents so that the signature page comes first. A version of this last method is to tag the signature pages only and then rush the borrower from signature page to signature page, ignoring the disclosures and loan information in between.
   c. Fail to deliver the required disclosures and subsequently forge the borrower's signature. Forged signatures may be accompanied by a false notarization.

2. The borrower is solicited for a fixed rate mortgage. The borrower commits themselves emotionally and financially to the transaction only to learn at closing that they have been switched into an ARM. The borrowers are convinced by controlling sales scripts that some element of their credit history, employment or property value disallows them to obtain the fixed rate loan they had been promised. The sales scripts combine delivery of negative information along with a reinforcement of the benefits the borrower will derive from the new loan, with some

of the benefits being direct lies or cover ups of the disadvantages associated with the loan. Throughout, the sales person focuses the borrower on "hot buttons": wants, issues, or problems that drove the borrower to consider refinancing in the first place.

It should be noted that the sales people are not above using fear and threats of financial damage to get the borrower to sign the closing papers. Many borrowers have relayed their discomfort and bewilderment during the closing process on these loan transactions.

3. Convincing the borrower that the ARM will automatically convert to a fixed rate mortgage after one year is a recurring sales theme identified by DFI. This sales pitch is generally used in conjunction with the deception in 2 above. It is employed on borrowers who refuse to accept the ARM despite the misrepresentations and pressure. Here the borrowers are promised that the loan will become a fixed rate loan after they have shown that they are able to make a year's worth of payments as agreed.

In other instances, a company provides the borrowers with a letter purporting to guarantee the conversion of the loan. However, a close reading of the letter shows that the company has promised nothing more to the borrower than to consider a full cost refinance after one year. In such situations the borrower is faced with large prepayment penalties and new costs to refinance.

4. An ARM loan is sold with the understanding that it holds similar amortization and interest rate savings as the fixed rate mortgage. In some instances, a company may use a deceptive disclosure that uses information derived from the Truth in Lending Disclosure to convince borrowers that ARMs amortize like fixed rate mortgages.[1] This disclosure and accompanying sales pitch convinces borrowers that the ARM holds the same benefits for them that the fixed rate mortgage holds. The borrowers are shown not only a reduced term to maturity (e.g. 30 years reduced to 15 years), but also a substantial interest savings.[2]

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[1] ARM loans do not amortize like fixed rate loans. The contractual principal reduction on fixed rate loans is known and fixed. Additions to principal above the monthly payment reduce the term to maturity. The amortization rate of principal on ARM loans varies annually based on changing rates. While additions to principal reduce the outstanding balance, the new balance is annually recast over the remaining term, thereby having an impact on payment. In other words, the term to maturity is not necessarily affected by additional payments to principal and due to changing rates the affect on payment remains unknown.

[2] DFI has recalculated the information given in many of these disclosures using "real" data and has found that the interest savings disclosed to the borrower is generally inaccurate by more than $100,000.

Loan Amount

The loan amount deception is generally accompanied by the loan cost deception and the monthly payment amount deception (discussed later). It has been alarming for regulators to find that the largest aid to the deceiver in this sales artifice is the federally required Truth in Lending Disclosure. The scam will often work like this:

The borrower has determined that they want a loan of a specific amount, say $80,000. The mortgage company proceeds to show the borrower an "Amount Financed" of $80,000 from the Truth in Lending Disclosure, while transacting a loan for $100,000 with the borrower.[3] Federal disclosure regulation requires the mortgage company to show the Amount Financed to the borrower, but does not require the borrower to be shown the actual loan amount.

DFI has reviewed sales scripts that employ dialogue such as:

> Borrower: "What is my loan amount?"
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> Sales Rep: "Your amount financed is $80,000."
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> Borrower: "So my loan amount will be $80,000?"
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> Sales Rep: "Make no mistake about it . . . your amount financed is $80,000 as you can see from this federal disclosure form."

The sales rep has not made a false statement, yet has led the borrower to believe that their loan amount is far less than they have signed for. The deception is held in what the sales rep did not say to the borrower. However, an unsophisticated borrower does not know that Amount Financed is a calculated disclosure unique to the Truth in Lending Disclosure and bears little resemblance to the loan amount they have obligated themselves to, and that the difference between the two is profit to the mortgage company. The borrower first finds out that they have a much larger loan than believed when they attempt to refinance or sell their residence.

The mortgage company's professed defense is that they have followed the federal disclosure requirements to the "T" and the borrowers did not choose to rescind the transaction within the rescission period.

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[3] The Amount Financed is derived by taking the loan amount and subtracting the Prepaid Finance Charge. The Prepaid Finance Charge will be comprised primarily of the mortgage company's loan origination and "junk" fees. Therefore, a $100,000 loan carrying fees of $20,000 will reflect an Amount Financed of $80,000.

<u>Loan Costs</u>

Borrowers have consistently reported that they were unaware of the costs paid on their loan. They have usually been sold on a no-cost or low-cost loan only to find that they have been switched to a high cost loan. It is not uncommon to find a borrower paying $10,000 to $15,000 in fees when they believed they would be paying little or no fee. There are many methods by which a mortgage company can hide its fees from the borrower. A couple are:

1. Failing to make disclosures of the fees. Federal regulations only require that Good Faith Estimates (GFEs) and Truth in Lending Disclosures (TILs) be placed in the mail within three days of the date of application (for refinance transactions the TIL doesn't even have to be given until just before consummation). No affirmative effort or verification of receipt is required on the part of the mortgage company. DFI has investigated complaints in which the consumer claims to have never received the disclosures, however, the company shows the disclosures in its files and claims to have placed them in the mail. This failure to make disclosures is believed to occur even at consummation of the transaction where the borrower never sees the disclosure, or sees a different disclosure, and their signature is subsequently forged on the real disclosure.

2. Borrowers are shown the disclosures, but are led to believe that the costs appearing on the GFE are either just examples, or will be covered for the borrower in the form of rebate to the mortgage company by the up-line lender. In some cases, a company will prepare the Itemization of Amount Financed disclosure to show the borrowers not paying the origination fee of several thousand dollars, when in reality the borrowers did pay these fees.

<u>Payment Amount</u>

An increasing concern among borrowers is the true amount of their monthly payment. It appears that borrowers are deceived about what is included in the monthly payment to make the loan more palatable. An example of this deception follows:

A borrower holds a current mortgage with a monthly payment of $1,000 including principal, interest, taxes and hazard insurance (PITI). The borrower is solicited for a new loan and is promised that their new payment will be only $900 per month. The borrower is informed that the new payment will include PITI and agrees to the transaction. The borrower does not find out until six months or a year later when taxes and insurance are due that their payment included only principal and interest (PI).

Once the taxes and insurance are factored in the borrower finds that their payment is actually higher than their old payment. This is often the point at which borrowers discover that they have an ARM, the loan amount is higher than they thought, they paid more than agreed in costs and a prepayment penalty prevents them from refinancing the loan.

<u>Prepayment Penalty</u>

For most loans, there is no prohibition against prepayment penalties. From the mortgage company's perspective there is an expectation of earnings on the loan for at least a reasonable period of time. A prepayment penalty is charged to offset the loss of this earnings expectation when a loan is refinanced in the early years following consummation.

Federal regulations require very little in disclosing prepayment penalties. The mortgage company's obligation is to include a fine print, vague reference to the existence of a prepayment penalty on the face of the TIL. This part of the disclosure is buried within a large amount of other information making the prepayment penalty disclosure less than conspicuous. Further, the prepayment penalty clause is carried deep within the note, is confusing to read and may be referenced as a "prepayment opportunity."

A standard prepayment penalty will require the borrower to pay six months worth of interest on any principal payment exceeding 20% of the original balance of the loan within the first five years. Obviously in a refinance transaction a borrower would be faced with a penalty of six months interest based upon 80% of the payoff on the loan . . . a sizable figure at any point during the first five years.

Generally, the deceptive mortgage company is able to avoid the question of prepayment penalty altogether. The borrower simply does not notice the fine print and does not query the sales representative on this matter. When the borrower does question the prepayment penalty they may be met with one of the following answers:

1. "There is no prepayment penalty." A direct lie, but effective if the borrower does not notice the buried disclosure.
2. "The lender will waive the prepayment penalty when you refinance." Again, a direct lie. The lender or investor in the loan has no incentive to waive the prepayment penalty as they invested in the loan based upon that protective feature.
3. The borrower is informed that all loans have a prepayment penalty and there is nothing that can be done about it. This is a false statement. Most loans do not have prepayment penalties and the prepayment penalty can be waived up-front in virtually all transactions.
4. "It is a prepayment opportunity." Here the borrower is informed that they have the opportunity to make up to 20% in principal reductions per year without a penalty. They are not informed that should they choose to refinance the loan (a goal of most borrowers agreeing to accept these types of "hard money" transactions) they will be faced with a large penalty.

DFI has found that there is incentive for loan officers to hide the existence of the prepayment penalty from the borrower. When a loan is sold in the secondary market, a loan with a prepayment penalty carries a premium relative to a loan without a prepayment penalty. When a loan officer cannot sell a borrower on a prepayment penalty, this loss of the premium on the sale of the loan is often passed down to the loan officer in the form of a reduced commission on the loan.

There are hidden damages in the prepayment penalty deception. Borrowers not understanding they have a prepayment penalty may realize financial loss by taking a refinance transaction nearly to conclusion only to find out at closing they cannot afford the refinance or all of the gain from the refinance is eaten up by the prepayment penalty. There are additional victims, however. Buyers of a property may find that the seller is unable to complete the sale due to a prepayment penalty and the seller of a new property to holder of the loan with the prepayment penalty may lose their sale as well. Additionally, third party providers such as Realtors, the new mortgage company, the escrow company and others are losing business to this type of deception.

Equity Skimming

All of the above categories of deception may constitute equity skimming in that the borrower's equity is skimmed away in the form of unknown costs or negatives associated with the transaction. However, direct equity skimming by mortgage companies is also alive and well. It is common for a borrower to simply lose their property to an unscrupulous mortgage professional. The fraud typically works like this:

The consumer is convinced that it is in their best interest to allow a claim to their property by the mortgage professional. This may be done for a variety of reasons:

1. The consumer has poor credit or work history or is unable to find financing due to factors such as age. The consumer quit claims the property to the mortgage professional who claims they will obtain a loan in their name for the consumer and then return the property after the loan has been arranged. A loan may be arranged by the professional to take out the underlying lender, however, the property is not returned to the consumer and is essentially stolen.
2. The consumer allows a recording of a lien against a portion of the property in exchange for fees owed in a loan transaction. While this may be a legitimate part of a transaction, the mortgage professional may intend to take over the borrower's property.
3. The consumer is convinced that the mortgage professional can sell the property for them and deliver the equity back minus a reasonable fee. In this case the borrower quit claims the property to the professional who subsequently sells the property and retains all the proceeds.
4. The mortgage professional assists the consumer with a refinance transaction, but claims a false debt that must be paid through escrow from the loan proceeds. The mortgage professional creates a fictitious, but legitimate sounding, credit source that draws no alarm by the escrow company. The mortgage professional is the recipient of payment on the false debt.